Petition and Transcript of Record

Supreme Court of the United States

OCTOBER TERM, 1931

No. 634

THE TEXAS & PACIFIC RAILWAY COMPANY, PETITIONER,

vs.

THE UNITED STATES.

ON WRIT OF CERTIORARI TO THE COURT OF CLAIMS

PETITION FOR CERTIORARI FILED JANUARY 14, 1932.

CERTIORARI GRANTED FEBRUARY 15, 1932.

(36,448)

(36,448)

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[fol. 1]

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1931

No. 634

THE TEXAS & PACIFIC RAILWAY COMPANY, Petitioner,

vs.

THE UNITED STATES, Respondent

PETITION FOR WRIT OF CERTIORARI TO THE COURT OF CLAIMS

To the Honorable the Chief Justice and the Associate Justices of the Supreme Court of the United States:

Your petitioner, The Texas & Pacific Railway Company, prays that a writ of certiorari issue to review the judgment of the Court of Claims of the United States entered in the above entitled case on October 20, 1931, and in support thereof, respectfully shows:

Summary Statement of Matter Involved

This is a suit brought in the Court of Claims to recover income and excess profits taxes in the sum of $208,138.01, part of the total taxes paid by the petitioner for the year [fol. 2] 1920, alleged to have been erroneously and illegally assessed and collected under the provisions of the Revenue Act of 1918, Act of Cong. February 24, 1919, c. 18, 40 Stat. 1057.

The petitioner is a railroad corporation and during the months of January and February, 1920, its properties were operated by the Director General of Railroads under the Federal Control Act, Act of Cong. March 21, 1918, c. 25, 40 Stat. 451. During the remainder of the calendar year 1920 the petitioner was operated by a receiver under a decree of court. Federal control terminated on February 29, 1920.

Under the Federal Control Act, the petitioner had a contract fixing the amount of just compensation during the Federal control period. The Transportation Act, 1920, Act of Cong. February 28, 1920, c. 91, 41 Stat. 456, termi-

nated the Federal control of railroads, and carriers, fulfilling certain conditions, were guaranteed a subsidy under the Act for the six months period after Federal control ceased, called the "guaranty period."

Under the provisions of the Transportation Act, 1920, the petitioner elected to take the guaranty provided by Section 209 (c) (1). Under that Section the United States guaranteed for the "guaranty period" as a whole, an amount not less than one-half of the annual amount named in the Federal control contract, such amount being determined as provided in the Act.

[fol. 3] Under this guaranty the United States paid the petitioner $2,043,041.77 and one of its subsidiaries $18,040.86, a total of $2,061,082.63. These amounts were included in gross income in the income tax returns filed for the year 1920.

The Commissioner of Internal Revenue upon audit consolidated the petitioner and its subsidiaries and determined a consolidated net income of $3,639,968.48 and assessed taxes of $363,796.85, for the year 1920. In this determination the Commissioner included as income the aggregate sum of $2,061,082.63, shown above.

The taxes so assessed by the Commissioner for the year 1920 were duly paid and two claims for refund were filed, one for the sum of $206,108.26 based upon the inclusion as income of the guaranty payments, and the other for $2,029.75 based upon minor items in the audit. The claims were rejected by the Commissioner of Internal Revenue and suit was filed in the Court of Claims.

That court rendered judgment for the petitioner in the sum of $1,962.90, sustaining the petitioner's contentions as to the minor items, but the court held that the $2,061,082.63 paid by the United States under the guaranty was taxable as income.

[fol. 4] Reasons Relied on for the Allowance of the Writ

1. This case presents for decision a principle of Federal law which involves the taxability for Federal income purposes of many millions of dollars paid by the United States to railroads under the guaranty provisions of Section 209 of the Transportation Act, 1920.

2. The question in this case is whether the amount of $2,061,082.63 paid by the United States as a subsidy to the

petitioner and its subsidiary under Section 209 (c) (1) of the Transportation Act, 1920, was taxable as income within the meaning of the Sixteenth Amendment and the provisions of the Revenue Act of 1918.

3. The question is one of large importance and wide public interest and has never been decided by this Court.

4. A final decision by this Court is necessary to settle other similar cases pending in the Federal Courts, before the United States Board of Tax Appeals and in the Bureau of Internal Revenue.

5. As shown by the debates in Congress (Cong. Rec. Vols. 58 and 59) the amounts paid to the petitioner and other railroads under Section 209 of the Transportation [fol. 5] Act, 1920, were in fact Government subsidies, were so intended, and were not income subject to tax.

6. The Court of Claims failed to follow the decisions of this Court wherein "income" has been repeatedly defined. The Court erroneously held that the amount paid to the petitioner and its subsidiary by the United States was taxable income.

Wherefore your petitioner prays that a writ of certiorari be issued out of and under the seal of this Honorable Court directed to the Court of Claims of the United States to review the judgment, record and proceedings had therein, and for such other, further and general relief, as to this Court may seem just and proper in the premises.

Respectfully submitted,

The Texas & Pacific Railway Company, by Adrian C. Humphreys, Adrian C. Humphreys, Newton K. Fox, Attorneys.

[fol. 1] IN THE COURT OF CLAIMS

No. K-148

THE TEXAS & PACIFIC RAILWAY COMPANY, Plaintiff,

v.

THE UNITED STATES

I. PETITION—Filed April 23, 1929

To the Honorable the Court of Claims:

The plaintiff in the above-entitled cause respectfully represents:

I

That it is a railroad corporation organized and existing under and by virtue of an Act of the Congress approved March 3, 1871, and having its principal office and place of business at Dallas, Texas.

II

That during the months of January and February, 1920, the plaintiff's properties were under Federal Control and operated by the Director General of Railroads; that during the remainder of the calendar year 1920 the plaintiff's properties were operated by a receiver under a decree of the District Court, Western District of Louisiana, Monroe Division, and that the receivership terminated at midnight on May 14, 1924.

III

That this suit arises under the Revenue Laws of the United States and is for the recovery of alleged income [fol. 2] taxes illegally and erroneously assessed against and collected from the plaintiff by the defendant under the alleged authority of the Revenue Act of 1918.

IV

That the plaintiff accepted the provisions of Section 209 of the Transportation Act, 1920 (41 Stat. L. 464); and for the so-called "Guaranty Period" the plaintiff received an allowance by the Interstate Commerce Commission, as representing the amount necessary to make good the guaranty under said Section 209 of the Transportation Act, 1920, in the sum of $2,043,041.77 and that the plaintiff's subsidiary The Denison & Pacific Suburban Railway Company received a like allowance in the sum of $18,040.86.

V

That on the form prescribed for that purpose the plaintiff filed with the Collector of Internal Revenue at Dallas, Texas, on March 15, 1921, its income and profits tax return for the year 1920; that said return reported a taxable net income of $3,331,767.11 and a tax liability of $332,976.71 and that said tax liability was paid to the said Collector of

Internal Revenue on the following dates and in the following amounts, to wit:

March 15, 1921	$83,244.18
June 4, 1921	83,244.17
September 7, 1921	83,244.18
December 10, 1921	83,244.18

and that said amounts were duly paid in to the Treasury of the United States by said Collector.

[fol. 3]

VI

That plaintiff's subsidiaries, The Weatherford Mineral Wells and Northwestern Railway Company and The Denison & Pacific Suburban Railway Company filed their respective income and profits tax returns for the year 1920 with the said Collector of Internal Revenue at Dallas, Texas, on March 5, 1921, and March 15, 1921; that said returns reported losses in the respective amounts $10,114.53 and $562.23; and that neither of said returns disclosed any tax liability.

VII

That under date of November 20, 1925, the Commissioner of Internal Revenue, upon audit of said returns, consolidated said returns and determined a consolidated net income of $3,858,969.80 and an alleged additional tax liability of $52,720.27; that among the adjustments set forth in said audit the Commissioner erroneously included as taxable net income the sum of $17,707.97 representing donations to the plaintiff in the form of spur tracks, side tracks, and other improvements.

VIII

That thereafter, under date of December 30, 1926, the said Commissioner made a revised audit of the returns of the plaintiff and its subsidiaries, and determined a consolidated net income of $3,586,524.78 and an alleged additional tax liability of $25,475.77 in lieu of his determination as set forth in his letter dated November 20, 1925; that in the revised audit set forth in said letter of December 30, 1926, the Commissioner erroneously disallowed as a deduction [fol. 4] from gross income the sum of $2,589.55 represent-

ing a portion of an assessment paid to the Association of Railway Executives of which plaintiff is a member.

IX

That thereafter, under date of April 8, 1927, the Commissioner of Internal Revenue made his final determination of plaintiff's tax liability for the year 1920; that said final determination was based upon a consolidated net income of $3,639,968.48; that the total tax liability as finally determined in said letter was allocated by the Commissioner to the plaintiff and its subsidiary, The Weatherford Mineral Wells and Northwestern Railway Company in the respective amounts $361,797.42 and $1,999.43; and that based upon said allocation the Commissioner determined a deficiency against the plaintiff in the sum of $28,820.71 and a deficiency against the said subsidiary in the sum of $1,999.43; and that said deficiency of $28,820.71 was paid to the said Collector of Internal Revenue at Dallas, Texas, on May 6, 1927, and was duly covered into the Treasury of the United States.

X

That the consolidated net income of the plaintiff and its subsidiaries, as finally determined by the Commissioner in his letter dated April 8, 1927, erroneously included as taxable income the said allowance on account of the "Guaranty Period" in the aggregate sum of $2,061,082.63 as well as the said items of donations in the sum of $17,709.97 and the said payment to the Association of Railway Executives in the sum of $2,589.55.

[fol. 5]

XI

That under date of June 21, 1927, on the form prescribed for that purpose, plaintiff filed with the Collector of Internal Revenue at Dallas, Texas, a claim for refund in the sum of $2,029.75 on account of taxes illegally and erroneously assessed and collected as set forth in paragraphs VII and VIII, supra; that said claim was rejected by the Commissioner of Internal Revenue on or about September 21, 1927; that thereafter, under date of March 31, 1928, plaintiff filed with the said Collector an additional claim for refund in the sum of $206,108.26 on account of taxes illegally and erroneously assessed and collected upon the allowance

of $2,061,082.63 referred to in paragraph IV, supra; and that said claim was rejected on or about June 14, 1928.

XII

That no action has been taken upon this claim other than herein set forth before Congress or any Department of the Government or in any Court; that no person other than the plaintiff is the owner thereof or interested therein; that no assignment or transfer of this claim or any part thereof or interest therein has been made; that the plaintiff is a citizen of the United States and has at all times borne true allegiance to the Government of the United States and has not in any way voluntarily aided, abetted or given encouragement to rebellion against said Government.

XIII

That the plaintiff, The Texas & Pacific Railway Company, avers that by reason of the facts hereinbefore set out there is now justly due and owing to it by the United States, the [fol. 6] sum of $208,138.01, with interest, after allowing all just credits and off-sets.

Wherefore plaintiff prays for judgment against the United States for $208,138.01, with interest to date of payment.

The Texas & Pacific Railway Company, by J. L. Lancaster, President. Chester A. Gwinn, Humphreys & Gwinn, Attorneys for Claimant, Munsey Building, Washington, D. C.

Duly sworn to by J. L. Lancaster. Jurat omitted in printing.

[fol. 7] II. GENERAL TRAVERSE—Filed June 1, 1929

And now comes the Attorney General, on behalf of the United States, and answering the petition of the claimant herein, denies each and every allegation therein contained; and asks judgment that the petition be dismissed.

Herman J. Galloway, Assistant Attorney General.

J. H. S.

III. Argument and Submission of Case.

On February 10, 1931, this case was argued and submitted on merits by Mr. Chester A. Gwinn, for plaintiff, and by Assistant Attorney General Charles B. Rugg, for defendant.

[fol. 8] IV. **Special Findings of Fact, Conclusion of Law and Opinion of the Court by Littleton, J.**—Filed October 20, 1931.

Mr. Chester A. Gwinn for the plaintiff.

Messrs. Humphreys & Gwinn were on the brief.

Mr. Montgomery B. Angell, amicus curiæ.

Mr. Assistant Attorney General Charles B. Rugg for the defendant.

Mr. Joseph H. Sheppard was on the brief.

This suit was instituted to recover $208,138.01, income tax alleged to have been erroneously and illegally collected for 1920, with interest.

The issues are (1) whether there should be included in taxable income $2,061,082.63 paid by the United States to the plaintiff under the provisions of section 209 of the transportation act of 1920 to make good an operating deficit of plaintiff for the guaranty period; (2) whether plaintiff is required to include as income for 1920 the amount of $17,707.97 representing the cost of constructing certain spur tracks which were paid for by the person for whose benefit they were constructed; (3) whether plaintiff is entitled to deduct a contribution to the Association of Railway Executives in the amount of $4,143.28 as an ordinary and necessary business expense.

As to the first issue, plaintiff contends that since section 209 of the transportation act of 1920 was not limited to railroads that had been under Federal control nor to carriers under Federal control contract, but applied to all carriers, whether or not under Federal control and whether or not under contract, the payment of the guaranty was not for services that had been rendered, but was a bounty bestowed upon all carriers accepting the provisions of the act and was for the purpose of rehabilitating the carriers after the disruption caused by the World War conditions and of

making it possible for them to operate during the readjustment period immediately following the World War; that the guaranty payments were therefore not income within the meaning of the sixteenth amendment to the Constitution.

On the second issue plaintiff contends that the cost of constructing spur tracks, paid for by the person for whose [fol. 9] use and benefit they were constructed, is not taxable income to the corporation. And with respect to the third issue it is contended that the contribution to the Association of Railway Executives was an ordinary and necessary business expense.

Special Findings of Fact

1. Plaintiff was organized under an act of Congress approved March 3, 1871, and has its principal office at Dallas Texas. During the months of January and February, 1920, its properties were under Federal control and were operated by the Director General of Railroads, and during the remainder of the calendar year 1920 its properties were operated by a receiver under a decree of the District Court, Western District of Louisiana, Monroe division, which receivership terminated at midnight on May 14, 1924.

2. Plaintiff accepted the provisions of section 209 of the transportation act of 1920, 41 Stat. 464 and received for the "guaranty period" mentioned by that act an allowance by the Interstate Commerce Commission representing the amount necessary to make good the guaranty under section 209, supra, in the sum of $2,043,041.77, and its subsidiary, the Denison & Pacific Suburban Ry. Company, received a like allowance of $18,040.86.

3. March 15, 1921, plaintiff filed an income and profits tax return for 1920 showing a net income of $3,331,767.11 and a tax of $332,976.71, which was paid in three equal installments of $83,244.18 on March 15, September 7, and December 10, 1921, and $83,244.17 on June 4, 1921. An overpayment of $11,099.22 resulted from the above payments by reason of the failure of the carrier to apply the two rates of tax applicable to the year 1920. The overpayment mentioned was refunded to the carrier by the Director General of Railroads in his administration of section 1 of the Federal control act in connection with section 230 (h) of the revenue act of 1918.

4. Plaintiff's subsidiaries, the Weatherford Mineral Wells & Northwestern Railway Company and the Denison & Pacific Suburban Railway Company, filed their respective income and profits tax returns for 1920 on March 5 and March 15, 1921. These returns showed no tax liability, but, on the contrary, reported losses in the respective amounts of $10,114.53 and $562.23.

5. November 20, 1925, the Commissioner of Internal Revenue audited these returns and held that the plaintiff and the two other railway companies mentioned were affiliated for 1920 and consolidated them for the purpose of the determination of the tax liability. He determined a consolidated net income of $3,858,969.80 and an additional tax of $52,720.27. Among the adjustments set forth in his audit the commissioner included in taxable income the amount of $17,707.97, representing donations in that amount to the plaintiff to pay for the cost of constructing certain spur and side tracks and other improvements. The total of the said donations to plaintiff consisted of the cost of materials and labor, all of a capital nature, used in the construction of said tracks, the total of which was credited on its books to profit and loss account No. 606, "Donations."

6. Thereafter, on December 30, 1926, the commissioner made a reaudit of the returns of plaintiff and its subsidiaries for 1920 and determined a consolidated net income of $3,586,524.78 and an additional tax of $25,476.77 in lieu [fol. 10] of his determination of November 20, 1925. In this reaudit the commissioner disallowed as a deduction from gross income the amount of $2,589.55, representing a portion of a contribution paid to the Association of Railway Executives which was assessed to the plaintiff by that association of which plaintiff was, and is, a member. The total amount paid by plaintiff to the Association of Railway Executives in 1920 as its proportion of expense of maintaining and furthering the activities of that association was $4,143.28. The commissioner allowed as a deduction from gross income only $1,553.73 of this amount.

The Association of Railway Executives is a voluntary association composed of officials of all Class I railroads, with one exception, and was organized many years ago for the purpose of attending to matters of common concern to the railroads. It was believed that the principal problem

confronting the railroads just prior to the war was the impairment of their credit, due in large measure to an unsympathetic public opinion. The World War and the consequent taking over of the railroad properties by the Director General of Railroads delayed the program which the association had tentatively adopted for correcting such unfavorable public impression.

Upon the close of the war and in view of the imminent return of railroad properties to private ownership, the association resolved in 1919 to renew its plans for presenting the cause of the railroads to the public by means of a nation-wide advertising campaign. An assessment was made against each member of the road, on a mileage basis, designed to raise a fund of $1,600,000, of which $1,000,000 was estimated to be necessary for carrying on such advertising campaign. The assessment was made payable in four equal installments, two of which fell within the calendar year 1919 and two within the calendar year 1920. The ratio of $1,000,000 to $1,600,000, or 10/16ths, was the basis for the commissioner's disallowance of $2,589.55 of the contribution made by the plaintiff in 1920.

The association expended a total of $828,518.40 in connection with a series of eight advertisements inserted in newspapers covering the entire country instead of $1,000,000 as estimated. The balance of $171,481.60 was turned into the general treasury of the association. The eight advertisements purported to outline the part which had been played by the railroads in the development and progress of the Nation, the reasonableness of freight rates, the tremendous investment in railroad properties, the necessity for additional capital to enable the railroads to keep abreast of the times, comparisons of American railroads with foreign railroads, and other problems then facing the railroads, and appealed to the public for a more sympathetic understanding of such problems and for confidence and cooperation in working out their solution.

7. April 8, 1927, the Commissioner of Internal Revenue made his final determination with respect to the tax liability for 1920, in which he determined a consolidated net income of $3,639,968.48. The total tax liability as finally determined in notices mailed April 8, 1927, was allocated by the commissioner to the plaintiff and its subsidiary, the Weatherford Mineral Wells and Northwestern Railway

Company, in the amounts of $361,797.42 and $1,999.43, respectively, and, based upon said allocation, the commissioner determined a deficiency against plaintiff of $28,820.71 and a deficiency against the subsidiary of $1,999.43. [fol. 11] May 6, 1927, plaintiff paid the deficiency of $28,820.71 determined by the commissioner with respect to its tax for 1920. This deficiency constituted in part an overpayment of tax which arose as a result of the failure of the Commissioner of Internal Revenue to apply the two rates of tax applicable to the year 1920. The amount of $960.69 was refunded to the carrier by the Director General of Railroads in his administration of section 1 of the Federal control act in connection with section 230 (b) of the revenue act of 1918. The net amount of tax therefore finally paid by the carrier was $349,737.51.

8. The consolidated net income of plaintiff and its subsidiaries as finally determined by the commissioner in his notice of April 8, 1927, included as taxable income the aforementioned allowance under section 209 of the transportation act of 1920 for the "guaranty period" in the aggregate sum of $2,061,082.63, as well as the aforementioned items of donations by the public of $17,707.97 and the contribution to the Association of Railway Executives of $2,589.55.

9. On or prior to December 19, 1925, plaintiff filed with the Commissioner of Internal Revenue a waiver of the limitation within which assessment of additional taxes for 1920 might be made extending the said limitation to December 31, 1926, and on or before December 20, 1926, plaintiff filed a second waiver for extending the time for assessment of additional taxes for 1920 to December 31, 1927.

June 21, 1927, plaintiff filed a claim for refund for 1920 of $2,029.75 on account of taxes alleged to have been erroneously and illegally assessed and collected as set forth in findings 5 and 6. This claim was rejected by the commissioner September 21, 1927. Thereafter, on March 31, 1928, plaintiff filed an additional claim for refund for 1920 of $206,108.26, alleged to have been erroneously and illegally assessed and collected upon the allowance of $2,061,082.63 included in income by the commissioner as above set forth. This claim was rejected June 14, 1928.

10. Plaintiff is the sole owner of this claim. No assignment thereof has been made and no action has been taken thereon before Congress, the courts, or in any department of the Government as hereinbefore set forth.

Conclusion of Law

Upon the foregoing special findings of fact, which are made a part of the judgment herein, the court decides, as a conclusion of law, that the plaintiff is entitled to recover $1,962.09, with interest.

It is therefore adjudged and ordered that the plaintiff recover of and from the United States the sum of one thousand nine hundred sixty-two dollars and nine cents ($1,962.09), with interest at the rate of six per cent per annum from May 6, 1927, to such date as the Commissioner of Internal Revenue may determine, in accordance with the provisions of section 177 (b) of the Judicial Code, as amended by section 615 of the revenue act of May 29, 1928.

Opinion

Littleton, Judge, delivered the opinion of the court:

On the first issue the plaintiff contends that the amount of $2,061,082.63 received from the United States under the [fol. 12] provisions of section 209 of the transportation act of 1920 to make good an operating deficit for the guaranty period was strictly a bounty or a subsidy from the sovereign to the railroad and, as such, was free from taxation by the United States. We are unable to agree with this contention. This question was before the United States Board of Tax Appeals in Gulf, Mobile & Northern Railroad Co. et al., 22 B. T. A. 233, wherein the board in a well-reasoned opinion reached the conclusion that such payments made by the United States under section 209 of the transportation act of 1920 constituted taxable income. We agree with the reasoning of the board and the conclusion reached in the above-mentioned case.

The plaintiff relies upon the case of Edwards v. Cuba Railroad Co., 268 U. S. 628, but we think that case is not in point. The payment made under section 209 of the transportation act was not a contribution to capital nor was it strictly and correctly a bounty or subsidy as would be

exempt from taxation. While there was no legal obligation on the part of the United States to make such payment to the railroads before section 209 of the transportation act became law, the Government was bound by legal obligation after the railroads had accepted the terms of this statute to make the necessary payments and the railroads were equally bound to pay certain excess earnings over the specified amounts to the Government. There was mutuality of arrangement and mutuality of benefit as well as of obligation. The whole matter of such payments grew out of the control and operation of most of the railroads in the country by the United States, and the purpose of the act providing for such payments was to guarantee to the railroads that for a period following the release of railroads from Federal control their operating income, of which their owners and security holders re[illegible]ved the benefit, would not be less than their average r[illegible]ay-operating income for the test period of three years prior to Federal control ending June 30, 1917. It was the railway-operating income in a specifically restricted sense which was guaranteed. The railroads, in order to receive the guaranty payments under section 209, were required to accept in writing all provisions of that section within a certain time. One of these conditions was, should the railway-operating income exceed a certain amount, the excess would be paid to the Government. This constituted a contractual agreement between the carrier and the Government, and it could not be ascertained until an accounting had been had whether the Government would pay the railroad or whether the railroad would pay the Government. This feature of the case takes away any basis for holding that the payments by the Government were pure gifts or subsidies to the railroads. Although Congress was impelled by no legal obligation in enacting this legislation requiring the Government to make these payments, it seems clear that the Government took into consideration the benefits to be derived by the people of the United States and that there were obligations of "an equitable, moral, and honorary nature" on the part of the Government existing on account of the condition of the railway systems immediately following Federal control and largely as a result thereof. United States v. Realty Co. et al., 163 U. S. 427. Such an obligation may well be said to take the place of a legal obligation to such an extent as to

take payments under section 209 of the transportation act out of the class of pure gratuities or subsidies. If the pay-
[fol. 13] ments by the Government to the railroads constitute gifts or gratuities free from tax, the question naturally arises as to the nature of payments made by the railroad to the Government where they had excess income. It would be a strained construction to say that amounts paid by the railroads to the Government where their income exceeded certain amounts were gifts by them to the Government. We think the railroads were not making voluntary contributions to the Federal Government, and certainly they did not so consider it. Nor do we consider that the Government was making gifts or voluntary contributions to the railroads where their operating income did not equal the guaranteed amount. As was well stated by the United States Board of Tax Appeals in Gulf, Mobile & Northern Railroad Co. et al., supra: "The payments by the Government, however, were dependent upon the operation of the railroad; that is, the use of both capital and labor. The payments were not received for the guaranty period unless the railroads were in operation during that period, and then only in the event that their operating income was less than the guaranteed amount, and we can not overlook the fact that it was railway-operating income which was guaranteed and made up. The Government derived a substantial benefit from the payments. It received consideration from the substantial good obtained for, or expected to be obtained for the people as a whole on account of the more efficient operation of the railroads and the further establishment of their credit."

For the foregoing reasons and for additional reasons fully stated and discussed by the United States Board of Tax Appeals in Gulf, Mobile & Northern Railroad Co. et al., supra; Missouri Pacific Railroad Co., 22 B. T. A. 267; Kansas City Southern Railway Co. and Affiliated Companies, 22 B. T. A. 949; Galveston Wharf Co., 22 B. T. A. 1312; and Chicago & North Western Railway Co., 22 B. T. A. 1407, we are of opinion that the Commissioner of Internal Revenue correctly held that the amounts received by the plaintiff from the Government under the provisions of section 209 of the transportation act constituted income for the year 1920.

The next issue concerns the question whether plaintiff was required to include in income for 1920 an amount representing the cost of constructing certain spur tracks which were paid for by the person or persons for whose benefit they were constructed. In the course of plaintiff's business as a carrier it is customary to construct spur tracks, side tracks, culverts, etc., at the request and for the benefit of persons and corporations along its right of way. The railroad furnishes the labor and materials for such construction and charges the actual cost thereof to the person for whose benefit the work was done and is reimbursed therefor by such beneficiary. To so much of such construction as is on plaintiff's right of way it acquires title and to that extent its capital account is increased. The actual cost of such improvements is, under a system of accounting prescribed by the Interstate Commerce Commission, required to be credited to profit and loss account No. 606, entitled "Donations."

We are of opinion that these transactions did not give rise to the receipt of taxable income by the plaintiff and that the defendant erroneously included in plaintiff's income for 1920 the amount of $17,707.97 on account thereof. Liberty Light & Power Co., 4 B. T. A. 155; Great Northern Railway Co., 8 B. T. A. 225.

[fol. 14] The last question is whether a payment of $4,143.28 made by plaintiff to the Association of Railway Executives, as set forth in finding 6, was an ordinary and necessary business expense allowable as a deduction from gross income for 1920. The Commissioner of Internal Revenue allowed a deduction of $1,553.73 of the total amount paid. This left a balance of $2,589.55. Plaintiff contends that this was an ordinary and necessary business expense and should be allowed as a deduction from gross income, while the defendant takes the position that the portion of the contribution disallowed falls within art. 562 of regulations 45 providing that sums of money expended for lobbying purposes, the promotion or defeat of legislation, the exploitation of propaganda, including advertising other than trade advertising, and contributions for campaign expenses, are not deductible from gross income.

We are of opinion that the nature of the contribution in question and the circumstances under which it was made bring it within the field of ordinary and necessary business

expense and that it should be allowed as a deduction from gross income. Great Northern Railway Co., supra; Texas & Pacific Ry. Co., 9 B. T. A. 365; Western Maryland Ry. Co., 12 B. T. A. 889; Los Angeles & Salt Lake Railroad Co., 18 B. T. A. 168; and Norfolk & Southern Railroad Co., 22 B. T. A. 302.

Judgment will be entered in favor of plaintiff for $1,962.09 with interest thereon at 6 per cent per annum, as provided by law. It is so ordered.

Whaley, Judge; Williams, Judge; Green, Judge; and Booth, Chief Justice, concur.

[fol. 15] V. JUDGMENT OF THE COURT

At a Court of Claims held in the City of Washington on the 20th day of October, A. D., 1931, judgment was ordered to be entered as follows:

Upon the foregoing special findings of fact, which are made a part of the judgment herein, the court decides, as a conclusion of law, that the plaintiff is entitled to recover.

It is therefore adjudged and ordered that the plaintiff recover of and from the United States the sum of one thousand nine hundred sixty-two dollars and nine cents ($1,962.09), with interest at the rate of six per cent per annum from May 6, 1927, to such date as the Commissioner of Internal Revenue may determine, in accordance with the provisions of section 177 (b) of the Judicial Code, as amended by section 615 of the revenue act of May 29, 1928.

VI. PROCEEDINGS HAD AFTER ENTRY OF JUDGMENT

On October 28, 1931, Chester A. Gwinn, Esq., of the firm of Humphreys & Gwinn, the attorneys of record, filed his withdrawal, leaving Adrian C. Humphreys, Esq., as the attorney of record.

[fol. 16] Clerk's certificate to foregoing transcript omitted in printing.

Endorsed on cover: File No. 36,448. Court of Claims. Term No. 634. The Texas & Pacific Railway Company, petitioner, vs. The United States. Petition for writ of certiorari and exhibit thereto. Filed January 14, 1932. File No. 36,448.

SUPREME COURT OF THE UNITED STATES

ORDER ALLOWING CERTIORARI—Filed February 15, 1932

The petition herein for a writ of certiorari to the Court of Claims is granted, and the case is assigned for argument immediately following the hearing of case No. 560, Continental Tie and Lumber Company vs. The United States.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

(1709)

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1931.

No. 634.

THE TEXAS & PACIFIC RAILWAY COMPANY, *Petitioner*,

vs.

THE UNITED STATES, *Respondent*.

BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI TO THE COURT OF CLAIMS.

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PRESS OF BYRON S. ADAMS, WASHINGTON, D. C.

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BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI TO THE COURT OF CLAIMS.

The Petitioner has filed a petition for a writ of certiorari to review a judgment of the Court of Claims.

I. Opinion of the Court Below.

The opinion of the Court of Claims was rendered on October 20, 1931, and is reported in 52 Fed. (2nd) 1040. (R. 13.)

II. Jurisdiction.

The jurisdiction of the Court is invoked under Section 3(b) of the Act of Cong. February 13, 1925, c. 229, 43 Stat. 936, 939, amending Section 240 of the Judicial Code.

The judgment of the Court of Claims was entered on October 20, 1931 (R. 17) and the petition for certiorari was filed on January 14, 1932. (R. 18.)

The case involves the taxability as "income" within the meaning of the 16th Amendment to the Constitution of a "subsidy" paid under Section 209 (c) (1) of the Transportation Act, 1920.

The following cases sustain the jurisdiction of the Court:

United States v. Ludey, 274 U. S. 295,
United States v. S. S. White Dental Mfg. Co., 274 U. S. 398,
Bonwit Teller & Co. v. United States, 283 U. S. 258.

III. Statement of the Case.

This is a suit to recover part of the income and excess profits taxes paid by Petitioner for the year 1920 under the provisions of the Revenue Act of 1918. (40 Stat. 1057.)

Petitioner is a railroad corporation and during the months of January and February, 1920, its properties were operated by the Director General of Railroads under the Federal Control Act. (40 Stat. 451.) Federal control terminated on February 29, 1920, and during the remainder of the calendar year 1920 the Petitioner was operated by a receiver under a decree of court.

Under the Federal Control Act, the Petitioner had a contract fixing the amount of just compensation during the Federal control period. The Transportation Act, 1920 (41 Stat. 456), terminated the Federal control of railroads, and carriers, under the Act were guaranteed a subsidy for the six months' period after Federal control ceased, called the "guaranty period".

Petitioner elected to take the "guaranty" provided by Section 209(c) (1) of the Transportation Act, 1920, and under this guaranty the United States paid the Petitioner and one of its subsidiaries $2,061,082.63. The Commissioner of Internal Revenue included that amount, as well as the earnings of the road, in gross income and assessed income and excess profits taxes for the year 1920 in the sum of $363,796.85. Petitioner paid the taxes of $363,796.85 and filed a claim for refund of $206,108.26 based upon the erroneous inclusion in income of the guaranty payment and a claim for $2,029.75 based upon minor items of adjustment. Upon rejection of the claims suit was filed in the Court of Claims.

The court rendered judgment for the Petitioner in the sum of $1,962.90, sustaining the Petitioner's contentions as to certain minor items, but the court held that the $2,061,082.63 paid by the United States under its guaranty was taxable income.

IV. Statutes Involved.

The Statutes involved are the Revenue Act of 1918 (Act of Cong. February 24, 1919, 40 Stat. 1057, c. 18) and Section 209(c) (1) of the Transportation Act, 1920 (Act of Cong. Feb. 28, 1920, 41 Stat. 456, 464, c. 91). Pertinent excerpts are set out in the appendix hereto.

V. Specifications of Error.

1. The Court of Claims erred in holding that the "subsidy" paid Petitioner under Section 209 of the Transportation Act, 1920, was taxable income within the meaning of the 16th Amendment to the Constitution and under the Revenue Act of 1918.

2. The Court of Claims erred in not entering judgment for the Petitioner in the sum of $201,200.07.

ARGUMENT.

The question of the taxability as "income" of subsidy payments under Section 209(c) (1) of the Transportation Act, 1920, is one of large importance to the railroads of the United States and is of wide public interest. It has never been passed upon by this Court and a decision is necessary to settle the question and the rule to be applied in other similar cases pending in the Federal Courts, before the United States Board of Tax Appeals and in the Bureau of Internal Revenue.

The question is not to be confused with payments made to the railroads as compensation for the use of its property during the Federal control period which ended February 29, 1920. Those payments are admittedly income and subject to tax.

Furthermore, Petitioner admits that the earnings of the road in 1920 are taxable income. It denies that the "subsidy" paid by the Government is "income".

1. Income Defined.

This Court in the case of *Eisner v. Macomber*, 252 U. S. 189, defined "income" within the meaning of the Sixteenth Amendment to the Constitution as follows:

"* * * 'Income may be defined as the gain derived from capital, from labor, or from both combined,' provided it be understood to include profit gained through a sale or conversion of capital assets, to which it was applied in the Doyle Case (pp. 183, 185).

"* * * The Government, although basing its argument upon the definition as quoted, placed chief emphasis upon the word 'gain,' which was extended to include a variety of meanings; while the significance of the next three words was either overlooked or misconceived. *'Derived-from-capital'*; *'the gain-derived-from-capital,'* etc." (p. 207)

The constitutional limitations upon the power of Congress to levy taxes must be strictly complied with and taxing acts are not to be extended by implication.

Eisner v. Macomber, 252 U. S. 189, 206, 211,
Nichols v. Coolidge, 274 U. S. 531, 540,
Blodgett v. Holden, 275 U. S. 142, 148,
Smietanka v. First Trust & Savings Bank, 257 U. S. 602, 605-6.

"In order, therefore, that the clauses cited from Article I of the Constitution may have proper force and effect, save only as modified by the Amendment, and that the latter also may have proper effect, it becomes essential to distinguish between what is and what is not 'income', as the term is there used; and to apply the distinction, as cases arise, according to truth and substance, without regard to form. Congress cannot by any definition it may adopt conclude the matter, since it cannot by legislation alter the Constitution, from which alone it derives its power to legislate, and within whose limitations alone that power can be lawfully exercised."

Eisner v. Macomber, 252 U. S. 189, 206.

Congress, under the 16th Amendment, has only the power to tax "income" in fact. If no income is in fact received there is no basis for the tax.

As this Court said in *Nichols v. Coolidge*, 274 U. S. 531:

> * * * "But under the mere guise of reaching something within its powers Congress may not lay a charge upon what is beyond them. Taxes are very real things and statutes imposing them are estimated by practical results." (page 541)

The "guaranty" payment under Section 209 of the Transportation Act of 1920 was not derived from capital or labor nor from the sale of its capital assets. It was a gratuity and does not come within the definition of "income".

2. The Guaranty Payment Was a Subsidy.

Payment under Section 209(c) (1) of the Transportation Act, 1920, was intended and was in fact a "subsidy" to the railroads. This is clearly shown by the debates in Congress prior to the passage of the Act where the payment was repeatedly referred to as a "gratuity", "subsidy" or "gift".

> Congressional Record, Vol. 58, Part 8, pp. 8342, 8355, 8448, 8453, 8454, 8458, 8466,—Part 9, pp. 8454, 8675, 8680, 9189.
> Congressional Record, Vol. 59, Part 4, pp. 3289, 3313, 3343, 8680.

As typical we quote Representative Kitchen (Congressional Record, Vol. 59, Part 4, p. 3313).

> "In my judgment, and I make the prediction, that it will require practically the entire amount

of the standard return for the six months, that is, $475,000,000, to make good the guaranty.

"Whatever the amounts shall be, it is an absolute gift by the Government to the railroads—the deliberate taking out of the pockets of the taxpayers and giving it to the railroad owners."

Representative Sims (Cong. Rec. Vol. 59, Part 4, p. 3289):

"But not satisfied with this burden upon the people, we give a subsidy for the first six months."

And again he declares (Cong. Rec. Vol. 58, Part 9, p. 8680):

"This House has just voted to guarantee the standard rental return to all railroads making application for increase of rates within a given time, which amounts to nobody knows how many million dollars, an absolute subsidy, an absolute gift."

Representative Steagall (Cong. Rec. Vol. 58, Part 9, p. 8675):

"They (the people) are going to be sorely disappointed when they learn that this bill looks to an increase of these burdens along with its enormous subsidy to the roads."

The guaranty payments were neither derived from capital, nor from labor, nor from both combined. They were not derived from the sale or conversion of capital assets. They were not derived from services rendered. They were not derived from any contract which either the carriers or the Government

entered into as a business transaction for profit. They were Government aids or subsidies to protect the public and insure an efficient transportation system during the six months' period following Federal Control.

The general purposes of payments under section 209 were stated by this Court in *United States v. Guaranty Trust Co.*, 280 U. S. 478, as follows:

> "* * * Congress deemed it important to preserve for the nation substantially the whole existing transportation system * * *. In order to accomplish this, it was thought necessary that the United States should, to a certain extent, finance the carriers until it would become possible to restore their credit, by increase of rates or otherwise. The provisions of Title II of Transportation Act, 1920, were framed to that end." (pp. 484-485)

See also Akron C. & Y. Co. v. U. S., 261 U. S. 184, 190.

3. A Subsidy Is Not Taxable as "Income."

This case is controlled by the decision of this Court in *Edwards v. Cuba R. R. Co.*, 268 U. S. 628, holding that subsidies paid to a railroad by the Cuban Government were not taxable as "income" within the 16th Amendment to the Constitution. In that case the Cuban Government granted subsidies to a New Jersey railroad corporation based on the number of miles of line constructed. To receive the subsidies the railroad company had to comply with definite requirements, namely, a 1/3 reduction in rates for employees and troops of the Government, special trains and rates in case of war, a reduction in first class rates and the carrying of public correspondence free. The primary

requirement was of course to construct the railroad and the purpose of the subsidy was construction and operation in the interests of the Cuban people. This Court said:

> * * * "The Cuban laws and contracts are similar to legislation and arrangements for the promotion of railroad construction which have been well known in the United States for more than half a century. Such aids, gifts and grants from the government, subordinate political subdivisions or private sources,—whether of land, other property, credit or money,—in order to induce construction and operation of railroads for the service of the public are not given as mere gratuities. * * * The subsidy payments were proportionate to mileage completed; and this indicates a purpose to reimburse plaintiff for capital expenditures. * * * The subsidy payments taxed were not made for services rendered or to be rendered. They were not profits or gains from the use or operation of the railroad, and do not constitute income within the meaning of the Sixteenth Amendment. See *Stratton's Independence v. Howbert*, 231 U. S. 399, 415; *Eisner v. Macomber*, 252 U. S. 189, 207; *Merchants' Loan & Trust Co. v. Smietanka, supra.*" (Pages 632-633.)

Furthermore, the value of property acquired by gift is excluded from gross income by section 213(b) (3) of the Revenue Act of 1918 (40 Stat. 1057, 1065).

4. There Was No Consideration or Legal Obligation for the Guaranty Payment.

The language used in section 209 of the Transportation Act is important. It states "The United States hereby guarantees". The statute provides "a guaranty" and refers to "the guaranty period".

The payment to Petitioner did not arise from any legal obligation on the part of the Government growing out of Federal Control. The Federal Control Act as supplemented by Sections 202 and 203 of the Transportation Act provided full compensation. Moreover Section 209 by its terms (c) (4) applied to carriers that had not been under Federal Control.

The Petitioner was not required to do anything in order to be entitled to the payment other than to operate its road during the six months' period after Federal Control ended on February 29, 1920.

The subsidy payment was in no sense for services rendered or to be rendered by the Petitioner. It was not profits or gains derived from the use or operation of the railroad.

> Birmingham Trust and Savings Co. v. Atlanta, etc., Ry. Co., 300 Fed. 173, 179.

In the *Cuba Railroad case* (*supra*), the railroad had to build and operate the railroad, agree to lower rates, etc. But this contractual obligation by the railroad was not held to render the payments "income". In this respect the instant case is even stronger than the *Cuba case* for here is an absence of conditions.

In Finance Docket No. 1176, 70 I. C. C. 115, 116, the Interstate Commerce Commission, having under consideration the provisions of Section 209 of the Transportation Act of 1920, said:

> "The guaranty under section 209 is wholly independent of any damages which the carriers may have suffered by reason of the temporary taking of their property during the period of Federal control. For all such damages the government must render just compensation; and by their acceptance of the provisions of section 209 the car-

riers have in no way surrendered or abated any claims arising out of Federal operation. The guaranty, therefore, *was not founded upon a legal obligation,* but upon the thought that in fairness it was the duty of the government to protect the income of the carriers, following the termination of Federal control, until such time as higher rates could be made effective under the provisions of section 15a of the interstate commerce act." (Italics ours.)

The guaranty payment lacked every characteristic which this Court has held must exist before there is "income" subject to tax. It was not "income" from "operation".

As to the general purposes of such subsidies in the *Cuba Railroad case* this Court said that they were given in order to "induce the construction and operation of railroads for the service of the public". The condition imposed was to "operate" as well as to construct. The nature of the payment cannot be determined by the use to which the payment is applied. Taxability does not depend upon whether the payment was used for capital additions or current expenses. If in its nature the payment is not income, it cannot be made income by the use to which it is put. In fact the payment was a pure Government aid or subsidy.

CONCLUSION.

The importance of the question involved warrants the granting of the petition and the allowance of the writ.

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APPENDIX.

Excerpts from the Revenue Act of 1918.
(40 Stat. 1057, c. 18)

Section 213. (40 Stat. 1065)

"Sec. 213. That for the purposes of this title (except as otherwise provided in section 233) the term 'gross income'—

(a) Includes gains, profits, and income derived from salaries, wages, or compensation for personal service (including in the case of the President of the United States, the judges of the Supreme and inferior courts of the United States, and all other officers and employees, whether elected or appointed, of the United States, Alaska, Hawaii, or any political subdivision thereof, or the District of Columbia, the compensation received as such), of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. The amount of all such items shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under subdivision (b) of section 212, any such amounts are to be properly accounted for as of a different period; but

(b) Does not include the following items, which shall be exempt from taxation under this title:

* * * * * * * * *

(3) The value of property acquired by gift, bequest, devise, or descent (but the income from such property shall be included in gross income);"

Section 233. (40 Stat. 1077)

"Sec. 233. (a) That in the case of a corporation subject to the tax imposed by section 230 the term 'gross income' means the gross income as defined in section 213, * * *"

Excerpts from the Transportation Act, 1920.
(41 Stat. 456, 464-467, c. 91)

Guaranty to Carriers After Termination of Federal Control.

"Sec. 209. (a) When used in this section—

The term 'carrier' means (1) a carrier by railroad or partly by railroad and partly by water, whose railroad or system of transportation is under Federal control at the time Federal control terminates, or which has heretofore engaged as a common carrier in general transportation and competed for traffic, or connected, with a railroad at any time under Federal control; and (2) a sleeping car company whose system of transportation is under Federal control at the time Federal control terminates; * * *

The term 'guaranty period' means the six months beginning March 1, 1920.

The term 'test period' means the three years ending June 30, 1917; and

The term 'railway operating income' and other references to accounts of carriers by railroad shall, in the case of a sleeping car company, be construed as indicating the appropriate corresponding accounts in the accounting system prescribed by the Commission.

(b) This section shall not be applicable to any carrier which does not on or before March 15, 1920, file with the Commission a written statement that it accepts all the provisions of this section.

(c) The United States hereby guarantees—

(1) With respect to any carrier with which a contract (exclusive of so-called cooperative contracts or waivers) has been made fixing the amount of just compensation under the Federal Control Act, that the railway operating income of such carrier for the guaranty period as a whole shall not be less than one-half the amount named in such contract as annual compensation, or, where the contract fixed a lump sum as compensation for the whole period of Federal operation, that the railway operating income of such carrier for the guaranty period as a whole shall not be less than an amount which shall bear the same proportion to the lump sum so fixed as six months bears to the number of months during which such carrier was under Federal operation, including in both cases the increases in such compensation provided for in section 4 of the Federal Control Act;

* * * * * * * * *

(d) If for the guaranty period as a whole the railway operating income of any carrier entitled to a guaranty under paragraph (1), (2), or (4) of subdivision (c) is in excess of the minimum railway operating income guaranteed in such paragraph, such carrier shall forthwith pay the amount of such excess into the Treasury of the United States. * * * Notwithstanding the provisions of this subdivision, any carrier may retain out of any such excess any amount necessary to enable it to pay its fixed charges accruing during the guaranty period.

* * * * * * * * *

(g) The Commission shall, as soon as practicable after the expiration of the guaranty period, ascertain and certify to the Secretary of the Treasury the several amounts necessary to make good the foregoing guaranty to each carrier. The Secretary of the Treasury is hereby authorized and directed thereupon to draw warrants in favor of each such carrier upon the Treasury of the United States, for the amount shown

in such certificate as necessary to make good such guaranty. An amount sufficient to pay such warrants is hereby appropriated out of any money in the Treasury not otherwise appropriated.

(h) Upon application of any carrier to the Commission, asking that during the guaranty period there may be advanced to it from time to time such sums, not in excess of the estimated amount necessary to make good the guaranty, as are necessary to enable it to meet its fixed charges and operating expenses, the Commission may certify to the Secretary of the Treasury the amount of, and times at which, such advances, if any, shall be made. The Secretary of the Treasury, on receipt of such certificate, is authorized and directed to make the advances in the amounts and at the times specified in the certificate, upon the execution by the carrier of a contract, secured in such manner as the Secretary may determine, that upon final determination of the amount of the guaranty provided for by this section such carrier will repay to the United States any amounts which it has received from such advances in excess of the guaranty, with interest at the rate of 6 per centum per annum from the time such excess was paid. There is hereby appropriated, out of any money in the Treasury not otherwise appropriated, a sum sufficient to enable the Secretary of the Treasury to make the advances referred to in this subdivision."